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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

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Arizona Corporation Commission

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IN THE MATTER OF THE APPLICATION OF
MONTEZUMA RIMROCK WATER
COMPANY, LLC FOR APPROVAL OF A
RATE INCREASE.

DOCKET NO. W-04254A-08-0361

IN THE MATTER OF THE APPLICATION OF
MONTEZUMA RIMROCK WATER
COMPANY, LLC FOR APPROVAL OF A
FINANCING APPLICATION.

DOCKET NO. W-04254A-08-0362

STAFF'S NOTICE OF FILING
RESPONSE TO
PROCEDURAL ORDER

On April 9, 2012, a procedural order was filed in the above captioned docket directing parties to answer several questions related to documents to be filed by the Montezuma Rimrock Water Company ("MRWC" or "Company") on April 13, 2012. Staff hereby provides its response to the questions posed within the procedural order.

The first question asked with respect to each document included in MRWC's April 13, 2012 filing whether, regardless of its title the document is a lease agreement and why or why not; if it is a lease agreement, whether it is a capital lease or an operating lease and why; and whether Commission approval is required for the document and why. The April 13, 2012 documents filed by MRWC included a copy of a water services agreement between the Company and Ms. Patsy Olsen ("Water Services Agreement"), terms and conditions of a lease between Ms. Olsen and Nile River Leasing dated March 16, 2012 ("Nile Lease"), and a contract for arsenic treatment system between Ms. Olsen and Kevlor Design Group dated February 28, 2012 ("Kevlor Contract"). Upon Staff's review of the documents, Staff believes that the Water Services Agreement represents a lease, that the lease is a capital lease, and because it is a capital lease, Arizona Corporation Commission ("Commission") approval will be necessary for the lease to go into effect.

1 The Water Services Agreement between Ms. Olsen and MRWC is a lease. The Water
2 Services Agreement is a lease because it is a contract between a lessor (Ms. Olsen) and a lessee
3 (MRWC) granting the lessee possession of arsenic treatment equipment for a set term in return for
4 stipulated payments. See Water Services Agreement at Paragraphs 2 (term) 5 (payments) and 7
5 (treatment fees).

6 Additionally, the Water Services Agreement is a capital lease rather than an operating lease.
7 Accounting Standards Codification ("ASC"), a codification of Generally Accepted Accounting
8 Principles ("GAAP") provides under ASC 840 a test for whether a lease is a capital lease or an
9 operating lease. Under the ASC 840 if a lease satisfies any one of four criteria, it is a capital lease.
10 The considerations are (1) the lease conveys ownership to the lessee at the end of the lease term; (2)
11 the lessee has an option to purchase the asset at a bargain price at the end of the lease term; (3) the
12 term of the lease is 75 percent or more of the economic life of the asset; and (4) the present value of
13 the rents, using the lessee's incremental borrowing rate, is 90 percent or more of the fair market value
14 of the asset. The Water Services Agreement satisfies condition 2 as it provides for the transfer of the
15 assets for \$1 at the end of the term. Water Services Agreement Paragraph 15. Consequently, the
16 Water Services Agreement is a capital lease because it satisfies at least one of the ASC 840 criteria.
17 Additionally, the Water Services Agreement satisfies condition 3 because the lease term is 20 years
18 but Staff believes that the life of the asset would be 25 years. Water Services Agreement at
19 Paragraph 2.1. The Water Services Agreement does not satisfy condition 1. Staff is in the process of
20 obtaining information from the Company so as to determine whether condition 4 is satisfied.

21 Because the Water Services Agreement is a capital lease, Commission approval is required.
22 A.R.S. § 40-302(A) provides that

23 Before a public service corporation issues stocks and stock certificates, bonds, notes
24 and other evidences of indebtedness, it shall first secure from the commission an order
25 authorizing such issue and stating the amount thereof, the purposes to which the issue
26 or proceeds thereof are to be applied, and that, in the opinion of the commission, the
27 issue is reasonably necessary or appropriate for the purposes specified in the order,
28 pursuant to § 40-301, and that, ***except as otherwise permitted in the order, such purposes are not, wholly or in part, reasonably chargeable to operative expenses or to income.*** Before an order is issued under this section, notice of the filing of the application for such order shall be given by the commission or the applicant in such form and manner as the commission deems appropriate. The commission may hold a

1 hearing, and make inquiry or investigation, and examine witnesses, books, papers and
2 documents, and require filing data it deems of assistance.

3 A.R.S. § 40-301(A) (emphasis provided). As the Water Services Agreement is a capital lease, it is
4 not an operating lease, which would be accounted for as an operating expense. Pursuant to A.R.S. §
5 40-302(A), Commission approval is required for the Water Services Agreement.

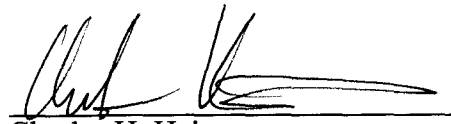
6 The second question asked whether the docket should remain open for consideration of
7 whether to modify Decision No. 71317 (October 30, 2009) under A.R.S. § 40-252 concerning
8 financial approval and related provisions. Decision No. 71317 provided MRWC with financing
9 authority to pursue a loan from the Water Infrastructure Financing Authority ("WIFA"). Decision
10 No. 71317 at 21:15 – 22:5. The Commission approved an A.R.S. § 40-252 proceeding in order to
11 evaluate alternatives to the WIFA financing that had been authorized in Decision No. 71317.
12 Because Commission approval of the Water Services Agreement is required and because Decision
13 No. 71317 was opened in order to consider financing alternatives to the WIFA loan, Staff believes
14 that it would be appropriate to leave the docket open in order to evaluate whether to modify Decision
15 No. 71317 to provide the necessary authorizations to pursue the Water Services Agreement as an
16 alternative financing method to attain the necessary arsenic treatment for the MRWC system.

17 The third and final question asked was, in the event that the docket is held open for further
18 proceedings to consider modification of Decision 71317 pursuant to A.R.S. § 40-252, whether an
19 evidentiary hearing should be held for such consideration. Staff does not believe an evidentiary
20 hearing is necessary for purposes of processing the Water Services Agreement although a hearing
21 could be had if deemed appropriate by the Administrative Law Judge. Financing applications are
22 typically processed either alone, or in the context of a rate case. When processed as just a financing,
23 there is typically not a hearing for the matter and Staff produces a Staff Report and the Hearing
24 Division produces a proposed order. When processed within a rate case, resolving if there is to be a
25 hearing is driven by whether the utility in question meets the size threshold where a hearing is
26 necessary. There was no evidentiary hearing for the rate case and financing approvals that led to
27 Decision No. 71317 because MRWC is below the size threshold where a hearing is necessary.

28

1 The Company remains a Class D utility and is therefore below the threshold where a hearing
2 is necessary. Additionally, the determination whether approval of the capital lease is appropriate is a
3 financing issue and a hearing would not be typical for such a matter. Likewise, evaluating the
4 appropriateness of a capital lease involves determining whether the utility has sufficient cash flow to
5 make the lease payments and does not involve the setting of rates. Staff notes that it has a data
6 request to the Company outstanding and as information is received and analyzed, Staff may revise its
7 recommendation.

8 RESPECTFULLY SUBMITTED this 27th day of April, 2012.

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10 
11 Charles H. Hains
12 Attorney, Legal Division
13 Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007
(602) 542-3402

14 **Original and fifteen (15) copies of**
15 **the foregoing filed this 27th day of**
April, 2012, with:

16 Docket Control
17 Arizona Corporation Commission
1200 West Washington Street
18 Phoenix, Arizona 85007

19 **Copy of the foregoing mailed this**
27th day of April, 2012, to:

20 Patricia D. Olsen, Manager
21 MONTEZUMA RIMROCK WATER COMPANY
P.O. Box 10
22 Rimrock, Arizona 86335

23 Todd C. Wiley
FENNEMORE CRAIG, P.C.
3003 North Central Avenue, Suite 2600
24 Phoenix, Arizona 85012

25 John Dougherty
26 P.O. Box 501
Rimrock, Arizona 86335

27
28 

EXHIBIT 1



ARIZONA CORPORATION COMMISSION

MEMORANDUM

DATE: April 26, 2012

TO: Charles H. Hains
Staff Attorney

FROM: Jeff Michlik *Jeff Michlik*
Public Utility Analyst V

RE: Montezuma Rimrock Water Company, LLC
Response to Procedural Order
(Docket Nos. W-04254A-08-0361 and W-04254A-08-0362)

The Commission has adopted the National Association of Regulatory Utility Commissions Uniform System of Accounts ("USOA") as the accounting standard for water utilities. The USOA states that leases shall be accounted for by a utility in accordance with the standards of the Financial Accounting Standards Board ("FASB"). Staff applied the criteria set forth in the FASB Accounting Standards Codification ("ASC")¹ to determine the proper classification of Patricia D. Olsen's lease ("Water Services Agreement") with Montezuma Rimrock Water Company LLC ("MRWC") as either a Capital lease or Operating lease. FASB ASC 840 provides specific guidance for the accounting of leases. FASB ASC 840 requires a lessee to classify a lease as capital lease if it meets any one of four criteria as follows:

- 1) The lease conveys ownership to the lessee at the end of the lease term.
- 2) The lessee has an option to purchase the asset at a bargain price at the end of the lease term.
- 3) The term of the lease is 75% or more of the economic life of the asset.
- 4) The present value of the rents, using the lessee's incremental borrowing rate, is 90% or more of the fair market value of the asset.

¹ The codification is effective for interim and annual periods ending after September 15, 2009. All existing accounting standards documents are superseded as described in FASB Statement No. 168, The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles. All other accounting literature not included in the Codification is nonauthoritative.

The Codification reorganizes the thousands of U.S. GAAP pronouncements into roughly 90 accounting topics and displays all topics using a consistent structure. It also includes relevant U.S. Securities and Exchange Commission (SEC), guidance that follows the same topical structure in separate sections in the Codification.

Based on examination of the Water Services Agreement between Patricia D. Olsen, and MRWC² Staff determined the following:

The lease conveys ownership to the lessee at the end of the lease term.

Under ASC 840-10-25-1 the transfer of title criterion is met in situation in which the lease agreement provides for the transfer of title at or shortly after the end of the lease term in exchange for the payment of a nominal fee. Paragraph 15 of the Water Services Agreement states:

15. Expiration of Agreement. Upon expiration of this Agreement, Company shall purchase from Olsen the Facilities for the sum of one dollar (\$1.00), provided Company has not exercised its option to purchase the Facilities in accordance with the terms in accordance with the terms Paragraph 2(2.1). Olsen shall coordinate the final purchase Company.

Thus, the transfer of ownership criterion for recognition of a capital lease is met by the Water Services Agreement.

The lessee has an option to purchase the asset at a bargain price at the end of the lease term.

Staff concludes that provision of paragraph 15 of the Water Services Agreement that provides for the lessee (MRWC) to acquire the asset (Arsenic Treatment Facility) for \$1.00 also represents a bargain price. Thus, the bargain price criterion for recognition of a capital lease is met by the Water Service Agreement.

The term of the lease is 75% or more of the economic life of the asset.

Paragraph 15 of the Water Services Agreement states:

2.1 Duration of Agreement. This Agreement shall commence on the date the Parties enter into this Agreement and shall continue for a period of 20 years from the Start-up Date (the "Term") unless this Agreement is earlier terminated pursuant to Section 15 below. At the end of the Term, Company shall have the option to purchase the Facilities for cash to be paid within thirty days from the expiration of the Term. Such option shall be exercised by notice given by Company to Olsen no later than sixty days prior to expiration of the Term.

Staff estimates the useful life for the Arsenic Treatment Facility at 25 years. The 20-year lease term represents 80 percent ($20 \div 25$) of the useful life. Thus, the 75 percent

² Please see Docket Nos. W-04254A-08-0361 and W-04254A-08-0362, filed on April 13, 2012.

of the economic life criterion for recognition of a capital lease is met by the Water Services Agreement.

The present value of the rents, using the lessee's incremental borrowing rate, is 90% or more of the fair market value of the asset.

Staff does not yet have the information to determine whether the present value of the lease payments is 90 percent of more of the fair market value of the asset at this time. Staff has requested the information needed to make this determination from the Company and is waiting on a response.³

Since a lease is classified as a capital lease if it meets any one of the four criteria, and Staff concludes that the Water Services Agreement meets three and possibly four of the criteria for recognition of a capital lease. Since meeting any one of the criteria results in classification of a capital lease, Staff concludes that the lease between Patricia D. Olsen and MRWC is properly classified as a capital lease.

³ Staff sent both an informal (email) and formal data request on April 25, 2012.